ANNUAL REPORT 1985

ROTHMANS OF PALL MALL CANADA LIMITED

ROTHMANS OF PALL MALL CANADA LIMITED
ANNUAL REPORT 1985

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The Annual Meeting of shareholders will be held at the Four Seasons Hotel, 21 Avenue Road, Toronto, Ontario, at 11:00 o'clock in the forenoon, on Wednesday, July 17, 1985.

Ce rapport peut être obtenu en français sur demande.

ROTHMANS OF PALL MALL CANADA LIMITED

CONSOLIDATED HIGHLIGHTS

	1985	1984	% Increase (decrease)
Year Ended March 31 ($000)			
SALES	**$1,472,899**	$1,490,706	(1.2)
EARNINGS	**24,292**	45,859	(47.0)
DIVIDENDS PAID:			
PREFERRED SHARES	**1,760**	1,798	(2.1)
COMMON SHARES	**8,817**	8,817	—
CAPITAL EXPENDITURES	**135,026**	82,103	64.5
At March 31 ($000)			
WORKING CAPITAL	**$149,428**	$174,520	(14.4)
TOTAL ASSETS	**818,166**	675,387	21.1
TOTAL INTEREST-BEARING DEBT	**136,755**	51,225	167.0
SHAREHOLDERS' EQUITY	**272,511**	259,629	5.0
Per Common Share			
EARNINGS	**$ 4.09**	$ 8.00	(48.9)
DIVIDENDS PAID	**1.60**	1.60	—
SHAREHOLDERS' EQUITY	**44.71**	42.29	5.7
Ratios			
RETURN ON AVERAGE TOTAL CAPITAL EMPLOYED	**7.7%**	17.2%	
RETURN ON SHAREHOLDERS' EQUITY	**9.1%**	18.9%	
WORKING CAPITAL RATIO	**1.64**	2.00	

CORPORATE PROFILE

Rothmans of Pall Mall Canada and its subsidiary companies are engaged in the production and sale of tobacco products, beer, wine, oil and natural gas.

The following are brief outlines of the principal companies in the Rothmans Canada group:

ROTHMANS OF PALL MALL CANADA LIMITED

The Company was incorporated in May 1956 and is Canada's second largest manufacturer and distributor of cigarettes. It also produces and sells fine cut tobacco and sells pipe and chewing tobacco, cigars and a number of other related products. Manufacturing operations commenced in October 1957 and are now carried out at plants in Toronto and Quebec City.

Principal cigarette trade marks are Rothmans, Craven "A", Number 7, Sportsman, Dunhill and Peter Stuyvesant.

CARLING O'KEEFE LIMITED

Carling O'Keefe was incorporated in the province of Ontario in 1930 and a majority interest (50.1%) was acquired by Rothmans in 1968 and 1969. Operations of Carling O'Keefe are carried out principally through four wholly-owned subsidiaries:

Carling O'Keefe Breweries of Canada Limited operates seven breweries in Canada. Principal brands owned by the company are O'Keefe, Old Vienna, O'Keefe's Extra Old Stock and Carling Black Label. Major brands brewed under licence are Carlsberg, Carlsberg Light, Miller High Life and Miller Lite. Exports of Old Vienna, O'Keefe and Cinci to the United States are distributed through an affiliated company. The company also owns hockey and football franchises, principally Le Club de Hockey Les Nordiques of the National Hockey League and the Argonaut Football Club of the Canadian Football League.

Jordan & Ste-Michelle Cellars Ltd. operates three wineries in Canada and sells under the trading styles of Jordan and Ste-Michelle. Principal brands are Maria Christina, Toscano, Spumante Bambino, Interlude and Falkenberg, as well as Growers Cider.

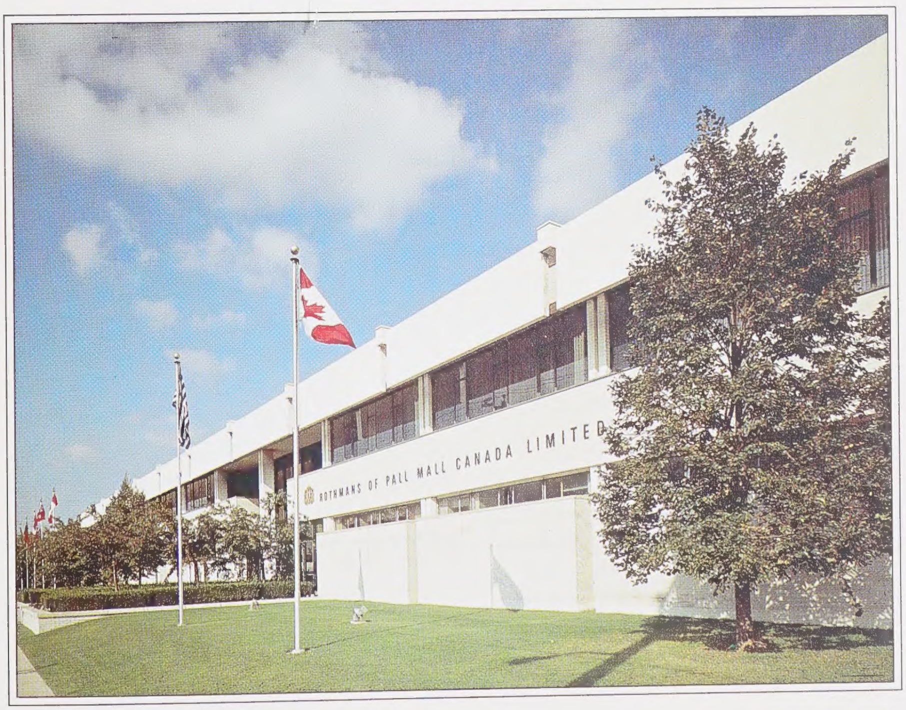
Star Oil & Gas Ltd. is engaged in the exploration for and the development and production of oil and gas, primarily in the provinces of Alberta and Saskatchewan.

Beamish & Crawford plc operates a brewery in Cork, Republic of Ireland. Principal brands are Carling Black Label, Carlsberg and Bass.

ROTHMANS OF PALL MALL CANADA LIMITED

HEAD OFFICE	—	1500 Don Mills Road, Don Mills, Ontario M3B 3L1
AUDITORS	—	Price Waterhouse
BANKERS	—	Bank of Montreal
REGISTRAR AND TRANSFER AGENT	—	The Royal Trust Company
SOLICITORS	—	Smith, Lyons, Torrance, Stevenson & Mayer

QUEBEC PLANT



TORONTO PLANT

REPORT TO SHAREHOLDERS

JOHN H. DEVLIN
CHAIRMAN OF THE BOARD

ROBERT H. HAWKES, Q.C.
PRESIDENT AND CHIEF EXECUTIVE OFFICER

CONSOLIDATED PERFORMANCE

After a number of years of growth, consolidated earnings declined to $24,292,000 or $4.09 per Common share, from last year's record earnings of $45,859,000 or $8.00 per share. Both the Company and its majority-owned subsidiary, Carling O'Keefe Limited, reported lower earnings in 1985, with the most significant decline occurring in Carling O'Keefe's Canadian brewing operations.

Earnings from the Company's tobacco operations amounted to $17,434,000 compared to $19,647,000 in 1984. The Company's share of Carling O'Keefe earnings was $6,858,000, versus $26,212,000 in the previous year.

Consolidated sales decreased by 1.2 percent to $1,472,899,000 in 1985. The lower amount reflected volume declines in all major product categories, partially offset by selling price increases.

Consolidated short term indebtedness at March 31, 1985 amounted to $51,878,000, compared to $18,111,000 a year earlier, primarily as a result of increased leaf tobacco and finished goods inventories in tobacco operations.

Dividends paid on Common shares of the Company remained unchanged at $1.60 per share. Rothmans has paid dividends without interruption since September 1974.

During the fourth quarter of the fiscal year, a consolidated loss of $782,000 or 22 cents per Common share was incurred, compared to earnings of $4,531,000 or 75 cents per share for the three months ended March 31, 1984. Tobacco operations recorded earnings of $1,061,000 versus $2,287,000 last year, while the Company's share of a Carling O'Keefe loss was $1,843,000, compared to earnings of $2,244,000 in 1984.

ROTHMANS TOBACCO OPERATIONS

The lower earnings reflected a further decline in cigarette sales and, in addition, lower volumes for fine cut tobacco for the roll-your-own market. Furthermore, the Company made a provision of $3 million (approximately $1.7 million after income taxes) for estimated costs of rationalization of production facilities. Sales of the Company's cigarette brands were down by 5.3 percent from 1984. Total industry sales were off by 2.1 percent.

Industry cigarette sales have now declined for three consecutive years, primarily because of the large number of tax-induced price increases during that period. The industry was again negatively impacted when the Federal Minister of Finance announced, in his budget of May 23, 1985, that the government had introduced an immediate tax increase of $2.00 per carton of 200 cigarettes, an increase of 44 percent in federal taxes. Furthermore, the federal sales tax rate will increase from 13% to 14% on January 1, 1986.

Representations have been made to provincial finance ministers and there were for the most part fewer and smaller adjustments in the past year in provincial tobacco taxes. The exception was the province of Quebec which increased its tobacco taxes by almost 45% during the last twelve months.

The 100 millimeter market, which for a number of years has been stable, showed growth. The Company introduced Rothmans Special Mild, Special Mild Menthol and Extra Light, and Craven "A" Ultra Light in this growing segment of the market. Since their successful introduction in Ontario, the three Rothmans brands have been extended to major urban markets in western Canada. Craven Ultra Light 100's was introduced in British Columbia and has added to the growing acceptance of the other Craven 100's. The regular length market, where the Company has limited representation, was also attacked. Sportsman Natural Light was initially launched in the Maritimes and was later extended to Quebec province. Number 7, which has had a strong franchise in its king size version in western Canada, was supplemented with regular length Virginia and menthol versions.

Significant efforts are continuing to reverse the market share decline which the Company has experienced. We are confident these problems will be overcome.

Ontario remains the Canadian tobacco industry's main source of flue-cured tobacco. The 1984 crop, which was sold at auctions during the period October 1984 to February 1985, totalled 170 million pounds with an overall average selling price of $1.69 per pound. The quality of the crop was better than average. For the current year, no agreement between the industry and the growers' marketing board has yet been reached. The Company's inventories of leaf tobacco have increased beyond our current requirements as a result of past agreements with the marketing board. The Company can no longer enter into arrangements which would have the effect of perpetuating such excess inventories.

During the year, labour contracts at both plants expired—on December 20, 1984 at Toronto and on March 19, 1985 at Quebec City. A new two-year agreement for the Quebec plant has been ratified and negotiations are continuing with the Toronto plant union.

Capital expenditures in 1985 totalled $10.6 million, compared to $8.3 million last year. The majority of the expenditures were for machinery, equipment and building renovations at the two plant locations in Quebec City and Toronto. Particular emphasis in the past few years has been on upgrading facilities at the older Quebec City plant, with significant improvements being made not only to the building itself, but also in leaf handling and processing equipment and in making and packing machinery.

CARLING O'KEEFE OPERATIONS

After six years of improving results, Carling O'Keefe Limited reported significantly lower earnings and reduced sales revenue. The continuation of the major capital investment program in the Canadian brewing operations resulted in a substantial increase in capital expenditures, some of which was financed by $62 million borrowed under floating rate revolving credit arrangements with the company's bankers.

It was a particularly difficult year for Carling O'Keefe Breweries of Canada Limited, with a sales volume decline of 11 percent and significantly lower earnings being reported. Lack of growth in the Canadian beer market and the company's success in 1984 resulted in a significant increase in the level of industry competition, which took the form of new brands, new packaging and an increase in the cost of marketing, particularly in sports related activities. As a result, operating and marketing costs increased. In addition, for much of the year the company was unable to fully supply the market because the expansion and renewal of production facilities was not complete. During the year, it became evident that the Canadian consumer preferred distinctive bottles and that the industry compact bottle was no longer acceptable to the majority of consumers. Accordingly, a decision was taken that the compact bottle being used by the company would have to be replaced. A provision of $20.6 million ($11.7 million after tax) was therefore made for the resulting bottle write-off.

A further negative factor was that operations in the province of Ontario were shut down for approximately four weeks in March as a result of an industry labour dispute.

The company's two professional sports franchises had satisfactory years. The Toronto Argonauts of the Canadian Football League finished first in their division but were defeated in a sudden death playoff game for the division title. The Quebec Nordiques finished seventh in the overall National Hockey League standings and reached the semi-finals of the Stanley Cup playoffs. Both franchises reported improved financial results and continued to make a positive contribution to the company's marketing efforts.

Beamish & Crawford plc, the Irish brewing subsidiary, had an excellent year and reported increased market share, sales volume, sales revenue and earnings.

Jordan & Ste-Michelle Cellars Ltd. had another difficult year and reported lower sales volume, sales revenue and earnings. Sales of Canadian produced wines declined for the second year in a row as a result of continued intense competition from imported wines. During the year, Jordan & Ste-Michelle took steps to defend its position in the table wine segment by launching new brands and remaining price competitive. Increased emphasis was also placed on the refreshment beverage category.

Star Oil & Gas Ltd. continued to concentrate its efforts in Canada, where improvements in government regulations and incentives provided the basis for better operating results. The company reported increased production of oil and natural gas and increased sales revenue and earnings. An agreement reached in March 1985 between the federal government and the governments of the provinces of British Columbia, Alberta and Saskatchewan will deregulate crude oil pricing in Canada and will eliminate the more onerous aspects of the National Energy Program. It is believed that these changes will prove to be beneficial to the oil and gas industry in Canada.

GENERAL

During the year, there were a number of changes in the Board of Directors of the Company. Joining the board were four new members—Sir Robert Crichton-Brown, K.C.M.G., C.B.E., T.D., Chairman, and Vernon A. Brink, Chief Executive, of Rothmans International p.l.c., the parent company of Rothmans Canada; S. Roderick McInnes, C.A., Chairman, President and Chief Executive Officer of the Company's subsidiary, Carling O'Keefe Limited; The Honourable William M. Kelly, a member of the Senate of Canada. Departing from the board was Sir David Nicolson, who had been a director of the Company since 1978. At the same time, Sir David also retired as Chairman and a director of Rothmans International p.l.c. Also retiring from the board was Donald R. Sobey, who felt he could not stand for re-election because of the pressure of many other business commitments. All of the Directors join in thanking Sir David and Mr. Sobey for their valuable contribution to the Company for the many years they served on the board.

On behalf of all directors, we would once again like to express our appreciation to our employees, shareholders, customers and suppliers.

John H. Devlin
Chairman of the Board

Robert H. Hawkes, Q.C.
President and Chief Executive Officer

May 23, 1985

ROTHMANS OF PALL MALL CANADA LIMITED

REVIEW OF TOBACCO OPERATIONS

($000)	1985	1984	1983	1982	1981
SALES—					
Cigarettes	**$534,548**	$519,609	$494,127	$469,858	$446,911
Domestic and imported tobacco	**18,923**	19,196	15,560	12,530	10,913
Cigars	**2,391**	2,172	2,104	2,454	2,371
All other products	**2,481**	1,263	422	564	1,296
	$558,343	$542,240	$512,213	$485,406	$461,491
EARNINGS—					
Before interest and income taxes	**$ 28,656**	$ 32,574	$ 38,270	$ 41,404	$ 40,812
Before income taxes	**$ 26,552**	$ 30,002	$ 32,994	$ 36,186	$ 35,891
For the year	**$ 17,434**	$ 19,647	$ 21,026	$ 22,221	$ 21,391
CAPITAL EXPENDITURES	**$ 10,569**	$ 8,303	$ 7,916	$ 5,492	$ 8,622
ASSETS EMPLOYED	**$263,276**	$226,259	$226,190	$223,858	$186,454

For the year ended March 31, 1985, earnings from tobacco operations amounted to $17.4 million, a decline of $2.2 million or 11.3 percent from 1984. The major unfavourable factors were lower unit sales of cigarettes and domestic tobacco and generally higher costs. Selling price increases and slightly lower interest costs were partial offsetting factors.

With the lower earnings, the rate of return on average total capital employed declined in 1985—to 9.7% from 12.3% in the previous year. Comparable figures for the preceding three years were 13.3% in 1983, 15.8% in 1982 and 16.6% in 1981.

Earnings for the last three months of the 1985 fiscal year were $1.1 million compared to $2.3 million in the same quarter last year. A major factor in the lower earnings was a provision of $3 million ($1.7 million after tax) for the estimated costs of rationalization of manufacturing facilities.

Statements of earnings, financial position and changes in financial position of tobacco operations can be found on pages 12 and 13. The following commentary reviews 1985 results versus those of the preceding year.

SALES

Sales revenue for the Company amounted to $558.3 million. This represented an increase of $16.1 million or 3 percent over 1984, with cigarette sales accounting for most of the gain. Higher revenue was also realized from sales of imported tobacco, cigars and cigarette tubes.

Sales of the Company's cigarettes generated revenue of $534.5 million in 1985, a gain of $14.9 million or 2.9 percent. The improvement was attributable to selling price increases. During the year, cigarette selling prices were raised in April and July 1984 and in January 1985 to cover higher operating costs, in September 1984 as a result of the automatic annual indexing of federal taxes, and in October 1984 due to an increase in the rate of federal sales tax. The Company's unit cigarette sales were 13.3 billion compared to 14.1 billion last year, a decline of 5.3 percent.

Total Canadian industry cigarette sales were 62.7 billion in 1985. This represented a decrease of 2.1 percent from sales of 64 billion in 1984.

Revenue from sales of the Company's fine cut, pipe and chewing tobacco totalled $18.9 million, down slightly from the previous year ($19.2 million). The decline was attributable to lower volume, which more than offset selling price increases. The Company sold 932,000 kilograms in 1985 compared to 1,023,000 kilograms last year.

Revenue from sales of cigars increased to $2.4 million from $2.2 million in 1984, an improvement of 10 percent. Volume was 4.3 million compared to 3.7 million in the previous year.

Sales of all other products grew by 96 percent to $2.5 million in 1985, reflecting the full year effect of new lines of disposable lighters and cigarette tubes which were introduced during the previous year.

FEDERAL AND PROVINCIAL TAXES

The Company's selling prices include the three federal taxes on tobacco products - excise duty, excise tax and sales tax. For 1985, these taxes amounted to $288.5 million, an increase of $11.9 million or 4.3 percent. As a percentage of total sales revenue, they represented 51.7 percent in the most recent year compared to 51 percent in 1984.

As a result of federal legislation initially introduced in October 1980, rates for excise duty and excise tax automatically increased on September 1 each year. Prior to the most recent year, the formula was related to the Tobacco Products and Smokers' Supplies Subgroup of the Consumer Price Index, which had resulted in annual increases in excess of 15% in the previous two years. As a result of recommendations from a joint government-industry task force, the annual adjustments were revised to relate to changes in the overall Consumer Price Index. In the year under review, this meant that the increase (September 1, 1984) was only 4.9%, resulting in adjustments of approximately 9 cents each in both excise duty and excise tax per carton of 200 cigarettes.

In his budget of May 23, 1985, the Minister of Finance for Canada decided to eliminate this automatic indexing formula. In lieu of the increase that would have been made September 1, 1985, he immediately increased the excise tax on a carton of cigarettes by $2.00.

Prior to the 1985 fiscal year, the rate of sales tax had remained unchanged at 12% for many years. Because this tax is related to selling price, the amount of tax automatically increases when selling prices are adjusted for either excise duty and excise tax increases or manufacturers' cost increases. During the past year, the rate of tax was increased to 13%, effective October 1, 1984. The total increase in sales tax per carton during the 1985 fiscal year amounted to about 10 cents. Subsequent to year-end, sales tax increased by a further 2 cents per carton as a result of a manufacturers' selling price increase in April 1985.

At the present time, the three federal taxes amount to $6.55 per carton of king size cigarettes, compared to $4.27 a year ago.

In addition to the federal taxes, all of the provinces and territories levy their own tobacco taxes. Furthermore, the provinces of Ontario, Newfoundland and Prince Edward Island impose sales tax on tobacco products. Since last year's annual report, there have been eleven provincial tobacco tax increases, including three in British Columbia.

Per carton of 200 King Size Cigarettes	Provincial Tobacco Tax: 1984 Annual Report	Increases: Amount	Increases: %	Current	Current Federal and Provincial Tax
British Columbia	$4.48	$0.96	21.4	$5.44	$11.99
Alberta	2.96	—	—	2.96	9.51
Saskatchewan	5.36	0.80	14.9	6.16	12.71
Manitoba	5.20	1.00	19.2	6.20	12.75
Ontario*	5.18	0.14	2.7	5.32	11.87
Quebec	4.97	2.23	44.9	7.20	13.75
New Brunswick	6.00	0.16	2.7	6.16	12.71
Nova Scotia	4.00	0.80	20.0	4.80	11.35
Prince Edward Island**	3.00	—	—	3.00	9.55
Newfoundland***	9.56	—	—	9.56	16.11
Yukon Territory	3.20	—	—	3.20	9.75
Northwest Territories	4.20	1.00	23.8	5.20	11.75

* excluding provincial sales tax of 7% ** excluding provincial sales tax of 10% *** excluding provincial sales tax of 12%

COSTS

Total costs for the Company, excluding excise, sales and income taxes, amounted to $243.3 million in 1985 compared to $235.6 million last year. This represented an increase of $7.7 million or 3.3 percent.

Raw materials and manufacturing costs charged against earnings totalled $153.4 million, compared to $153.6 million in 1984. The cost of leaf tobacco expensed amounted to $57 million or $2.01 per pound (1984—$57.3 million; $1.87 per pound). Packaging material costs were $40.4 million compared to $41.7 million a year ago. Direct labour costs in 1985 were $19.6 million (1984—$19.4 million). Manufacturing overheads charged against earnings totalled $30.6 million compared to $30.5 million last year.

Marketing and distribution expenses increased by $3.9 million or 6.4 percent to $64.1 million. Most of the higher amount was attributable to increased media and sales promotion expenditures.

Administrative and general expenses were $23.6 million in 1985, up by $4.5 million or 23.3 percent from the previous year. Significant items which contributed to this increase were salaries and related benefits, data processing costs, building operating costs, packaging material write-offs and the rationalization provision. In addition, last year's cost had been reduced by significant amounts for sales tax refunds and revenue under royalty agreements.

Interest expense was $2.1 million, a decline of $0.5 million or 18.2 percent from 1984. Long term debt interest was lower as a result of purchases of the Company's debentures for sinking fund requirements. Short term debt interest was down because of lower average borrowing levels and interest rates during the year.

INCOME TAXES

The provision for income taxes amounted to $9.1 million compared to $10.4 million in 1984. As a percentage of pre-tax earnings, the 1985 provision was 34.3% compared to 34.5% last year.

As in prior years, income taxes are accounted for on the tax allocation basis for all timing differences between accounting and taxable income, with the principal difference being between accounting and tax depreciation of capital assets.

FINANCIAL POSITION

Excluding its investment in Carling O'Keefe Limited, the Company's assets amounted to $263.3 million at March 31, 1985, compared to $226.3 million at the previous year end. The main changes were increases of $27.1 million in inventories, due to both leaf tobacco and finished goods, and $5.6 million in net property, plant and equipment. In total, inventories of $180.8 million represented 69 percent of assets employed, compared to $153.7 million or 68 percent at March 31, 1984.

During the 1985 fiscal year, the Company's short term indebtedness increased by $24.3 million, amounting to $53.2 million at year end. The most significant uses of cash were for an increase in operating working capital, dividends, capital expenditures, and the retirement of long term debt. Earnings adjusted for non-cash items and dividends from Carling O'Keefe Limited were the main cash generators.

Operating working capital (current assets less current liabilities excluding short term indebtedness) increased by $29.3 million during the year; this compares to a decrease of $9.2 million in 1984. The majority of the higher amount was related to the increase in inventories of leaf tobacco and finished goods. Both inventories were higher in part because of increased costs. In addition, leaf tobacco inventories increased because, in accordance with a contract with the growers' marketing board, the Company purchased its share of a surplus of 1984 Ontario crop.

Total dividends paid by Rothmans on its Common and Preferred shares amounted to $10.6 million, virtually the same as last year. There was no change in the quarterly rate of 40 cents per Common share which was instituted in September 1981. Dividends on the two classes of preferred shares were marginally lower because of First Preferred shares purchased for cancellation.

Capital expenditures for the most recent year totalled $10.6 million, compared to $8.3 million in 1984. The majority of the expenditures were for machinery, equipment and building renovations at the two plant locations in Quebec City and Toronto.

The cost of long term debt retired during the year through purchases for sinking funds was $1.4 million. At March 31, 1985, $762,000 of sinking fund requirements due in the 1986 fiscal year had been discharged.

Carling O'Keefe Limited increased its quarterly common share dividend payout from 10 cents to 12 cents effective October 1, 1984. As a result, dividends received by the Company during the 1985 fiscal year increased to $5 million from $4 million in the previous year.

ROTHMANS OF PALL MALL CANADA LIMITED

EARNINGS FROM TOBACCO OPERATIONS

(in thousands of dollars)

	Year ended March 31	
	1985	1984
Income:		
Sales	$558,343	$542,240
Excise and sales taxes	288,497	276,606
	269,846	265,634
Costs:		
Raw materials and manufacturing	153,426	153,634
Marketing and distribution	64,149	60,273
Administrative and general	23,615	19,153
Interest on long term debt	1,602	1,800
Other interest	502	772
	243,294	235,632
Earnings before income taxes	26,552	30,002
Income taxes:		
Current	8,396	9,190
Deferred	722	1,165
	9,118	10,355
Earnings for the year	$ 17,434	$ 19,647

CHANGES IN FINANCIAL POSITION OF TOBACCO OPERATIONS

(in thousands of dollars)

	Year ended March 31	
	1985	1984
Cash provided by (used for):		
Operations—		
Earnings from tobacco operations	$ 17,434	$ 19,647
Adjusted for non-cash items—		
Depreciation	4,306	3,107
Deferred income taxes	722	1,165
Other items	(228)	201
	22,234	24,120
Disposal of property, plant and equipment	786	391
Decrease (increase) in operating working capital	(29,346)	9,220
Additions to property, plant and equipment	(10,569)	(8,303)
Other	(71)	(120)
	(16,966)	25,308
Financing activities—		
Dividends from Carling O'Keefe Limited	5,017	4,036
Dividends paid	(10,577)	(10,615)
Reduction of long term debt	(1,442)	(1,557)
Purchase of First Preferred shares	(338)	(353)
	(7,340)	(8,489)
Decrease (increase) in short term indebtedness	(24,306)	16,819
Short term indebtedness at beginning of year	(28,845)	(45,664)
Short term indebtedness at end of year	$(53,151)	$(28,845)

ROTHMANS OF PALL MALL CANADA LIMITED
FINANCIAL POSITON OF TOBACCO OPERATIONS
(in thousands of dollars)

	March 3l	
	1985	1984
ASSETS		
Current assets:		
Accounts receivable	$ 34,992	$ 30,121
Inventories	180,787	153,711
Prepaid expenses	2,072	1,698
Total current assets	217,851	185,530
Investment in Carling O'Keefe Limited, on the equity basis	119,524	118,178
Property, plant and equipment	98,608	91,003
Less: Accumulated depreciation	51,576	49,598
	47,032	41,405
Other assets	573	583
	$384,980	$345,696
LIABILITIES		
Current liabilities:		
Bank and other short term indebtedness	$ 53,151	$ 28,845
Accounts payable and accrued liabilities	20,065	17,715
Income taxes	765	985
Excise, sales and other taxes	15,550	14,706
Total current liabilities	89,531	62,251
Long term debt	13,450	15,050
Total liabilities	102,981	77,301
DEFERRED INCOME TAXES	9,488	8,766
SHAREHOLDERS' EQUITY		
Capital Stock:		
Preferred shares	26,022	26,476
Common shares	27,349	27,349
	53,371	53,825
Retained earnings	221,018	207,135
Unrealized foreign currency translation adjustments	(1,878)	(1,331)
Total shareholders' equity	272,511	259,629
	$384,980	$345,696

CARLING O'KEEFE LIMITED
REVIEW OF BREWING, WINE AND OIL AND GAS OPERATIONS

($000)	1985	1984	1983	1982	1981
SALES—					
Beer	**$833,449**	$869,287	$709,820	$583,281	$481,189
Wine	**57,731**	59,348	58,238	48,563	44,021
Oil and gas	**23,376**	19,831	16,169	12,289	12,138
	$914,556	$948,466	$784,227	$644,133	$537,348
EARNINGS FROM OPERATIONS—					
Before interest and income taxes—					
Beer	**$ 8,154**	$ 73,043	$ 63,325	$ 34,120	$ 24,331
Wine	**3,225**	5,596	5,741	3,949	1,512*
Oil and gas	**10,015**	9,089	1,389	3,907	5,729
Corporate	**(2,412)**	676	151	—	3,947
	$ 18,982	$ 88,404	$ 70,606	$ 41,976	$ 35,519
Before income taxes	**$ 16,697**	$ 87,645	$ 68,609	$ 37,734	$ 32,421
For the year	**$ 15,694**	$ 54,320	$ 38,069	$ 22,774	$ 19,785
CAPITAL EXPENDITURES—					
Beer	**$109,310**	$ 63,174	$ 24,480	$ 15,527	$ 15,637
Wine	**4,153**	1,855	1,920	2,619	2,050
Oil and gas	**10,994**	8,771	7,024	6,972	8,800
	$124,457	$ 73,800	$ 33,424	$ 25,118	$ 26,487
ASSETS EMPLOYED—					
Beer	**$422,474**	$317,892	$242,599	$210,367	$187,627
Wine	**58,534**	57,680	56,032	55,867	52,801
Oil and gas	**73,090**	66,091	60,287	63,513	58,967
Corporate	**792**	7,465	31,367	11,930	18,103
	$554,890	$449,128	$390,285	$341,677	$317,498

* 91.9% share

CONSOLIDATED OPERATIONS

For the year ended March 31, 1985, earnings of Carling O'Keefe Limited and its subsidiaries amounted to $15.7 million, compared to $54.3 million in the previous year. The decline was primarily attributable to Canadian brewing operations, where lower volume and a provision for bottle write-off both had a significant negative impact on results for 1985.

As a result of the substantial reduction in earnings, the rate of return on average total capital employed fell to 6.7% from 20.5% in 1984 (1983—15%; 1982—12%; 1981—11%).

For the final quarter of the fiscal year, there was a loss of $3.2 million versus earnings of $5 million for the three months ended March 31, 1984.

Total sales revenue for the most recent fiscal year was $914.6 million, down from $948.5 in the previous year. Lower volumes for Canadian beer and wine sales were only partially offset by increased selling prices.

Net cash at March 31, 1985 was $1.3 million compared to $10.7 million at the previous year-end. Major uses of cash during the year were capital expenditures and dividends paid.

Cash flow was enhanced by term bank loans and earnings adjusted for non-cash items.

Total assets of the company and its subsidiaries amounted to $554.9 million at the end of the 1985 year, compared to $449.1 million a year earlier. Most of the increase was attributable to property, plant and equipment, which was up by a net amount of $103.1 million after deducting depreciation and depletion.

Statements of earnings, financial position and changes in financial position for the company's consolidated operations are on pages 18 and 19. A copy of Carling O'Keefe's 1985 annual report is enclosed to provide more detailed information.

CANADIAN BREWING

Earnings before interest expense and income taxes of Carling O'Keefe Breweries of Canada Limited declined to $4.8 million from $70.9 million in 1984.

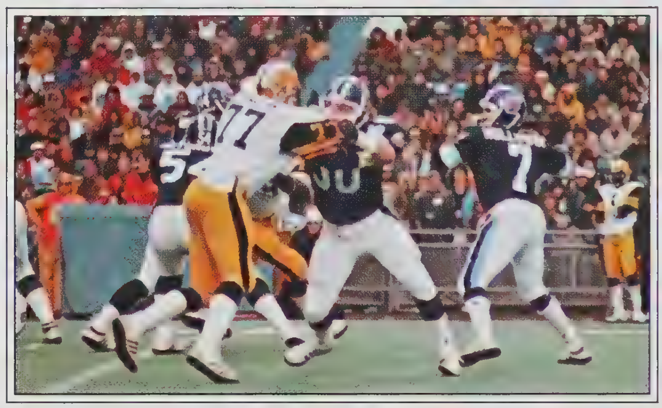
The company's sales volume totalled 5,340,000 hectolitres compared to 5,990,000 hectolitres in the previous year, a decrease of approximately 11 percent. An unprecedented level of industry competition and frequent product shortages caused by disruptions at the plants as a result of the major construction program were major factors. Despite the production problems, the company was active in the market place. Miller High Life was introduced in British Columbia, Alberta and

Newfoundland in May 1984. In January 1985, Trilight was introduced in Alberta. In late February and early March of 1985, Lite beer from Miller was launched nationally in all provinces except Ontario, where the launch was delayed until late March as a result of an industry labour dispute. During the year, 355 ml aluminum cans were introduced in most provincial markets and 473 ml aluminum cans were launched in Ontario, Manitoba and British Columbia. Subsequent to year-end, Carlsberg and Carlsberg Light were introduced in Ontario and Quebec in a private mould bottle featuring a twist off crown.

Sales volume of the Canadian brewing industry increased only marginally over last year. There were numerous packaging changes, with competitors converting existing brands from the industry compact bottle to a variety of private mould bottles of various sizes and closures. The aluminum can became a significant package in most provincial markets and there was continued growth in the popular priced beer segment.

As it became evident that the consumer had a strong preference for distinctive bottles, Carling O'Keefe decided to replace its existing supply of compact bottles and a provision of $20 million was made to write off the cost of the remaining inventory.

The extensive capital program to renew and expand the production facilities, which began during the 1982 fiscal year, will be completed during the 1986 fiscal year. Expenditures in 1985 totalled $107.5 million. The Calgary and Vancouver projects are virtually complete. The major expansion of the Toronto brewery will be operational by the summer of 1985. Completion of the program will provide the company with sufficient capacity to supply each provincial market.



IRISH BREWING

Beamish & Crawford plc had an excellent year and reported significant increases in sales volume, sales revenue and earnings.

Earnings before interest expense and income taxes amounted to $3.3 million compared to $2.1 million in 1984. Sales revenue was up by 21 percent to $54.7 million.

The company's sales volume increased 24 percent—to 328,000 hectolitres from 264,000 hectolitres in the previous year. With industry sales volume relatively unchanged, there was a continued increase in share of market. Sales of the company's lager brands, Carling Black Label and Carlsberg, continued to improve and were a major positive factor. The increased sales also benefitted from a five-week strike at a major competitor.

WINE

Earnings before interest and income taxes of Jordan & Ste-Michelle Cellars Ltd. were $3.2 million compared to $5.6 million in 1984.

The company's sales volume of 222,000 hectolitres declined by 2 percent from last year (226,000 hectolitres). Sales volume was lower in all regions of Canada except for British Columbia, which reported excellent growth in cider sales. The company's share of the national wine market declined slightly, reflecting a lack of full participation in the growing Quebec market and lower sales in other regions.

The total wine market in Canada grew by approximately 4 percent during the year, compared to an increase of 0.5 percent in 1984. Sales of Canadian produced wines declined by 1 percent, and now hold approximately 45 percent of the total market.

As a result of the brewing industry's move away from the compact bottle, the company made a provision of $600,000 to write off its supply of compact bottles used to package cider.

OIL AND GAS

Star Oil & Gas Ltd. had a satisfactory year and reported increased production of natural gas and crude oil, higher sales revenue and increased earnings.

Earnings before interest expense and income taxes were $10 million in 1985, an increase of about 10 percent over earnings of $9.1 million a year earlier.

Sales revenue was up by 18 percent to $23.4 million, a result of both increased production and higher selling prices. Natural gas production increased by 10 percent over last year. Production of crude oil and natural gas liquids increased by 6 percent.

Capital spending on exploration for and development of new reserves of crude oil and natural gas and on facilities for production increased by 25 percent to $11 million. In Canada, the company continued to acquire additional petroleum and natural gas leases and acquired an interest in oil producing areas in Saskatchewan and Alberta. The company restricted its activities in the United States.

INTERNATIONAL DIVISION

Royalty income from the sale of Carling Black Label in overseas markets, where it is produced under licence, was $1.5 million, marginally higher than in the previous year. Sales volume and the rate of royalty payments increased over 1984, but were offset by unfavourable exchange factors on conversion of pound sterling royalties to Canadian dollars.

EARNINGS FROM OPERATIONS

(in thousands of dollars)

	Year ended March 31	
	1985	1984
Income:		
Sales	$914,556	$948,466
Excise and sales taxes	327,369	335,134
	587,187	613,332
Investment and other income	3,600	6,512
	590,787	619,844
Costs:		
Raw materials and manufacturing	304,196	279,109
Marketing and distribution	228,007	216,169
Administrative and general	39,602	36,162
Interest on long term debt	1,578	522
Other interest	707	237
	574,090	532,199
Earnings before income taxes	16,697	87,645
Income taxes:		
Current	(7,063)	23,581
Deferred	8,066	9,744
	1,003	33,325
Earnings for the year	$ 15,694	$ 54,320

CHANGES IN FINANCIAL POSITION

(in thousands of dollars)

	Year ended March 31	
	1985	1984
Cash provided by (used for):		
Operations—		
Earnings for the year	$ 15,694	$ 54,320
Adjusted for non-cash items—		
Depreciation and depletion	19,421	14,339
Deferred income taxes	8,066	9,744
Other items	1,035	1,254
	44,216	79,657
Disposal of assets	1,672	1,031
Decrease (increase) in operating working capital	19,779	(11,875)
Additions to property, plant and equipment	(124,457)	(73,800)
Additions to other assets	(374)	(2,828)
	(59,164)	(7,815)
Financing activities—		
Increase (decrease) in long term liabilities	60,074	(2,868)
Current portion of other assets	1,797	—
Dividends	(12,022)	(10,074)
Purchase of preference shares	(146)	(144)
	49,703	(13,086)
Decrease in net cash	(9,461)	(20,901)
Net cash at beginning of year	10,734	31,635
Net cash at end of year	$ 1,273	$ 10,734

FINANCIAL POSITION

(in thousands of dollars)

	March 31 1985	March 31 1984
ASSETS		
Current assets:		
Cash and short term investments	$ 4,334	$ 11,705
Accounts receivable	48,566	46,505
Income taxes	9,730	528
Inventories	97,273	99,716
Prepaid expenses	8,430	6,745
Total current assets	168,333	165,199
Property, plant and equipment	500,757	384,460
Less: Accumulated depreciation and depletion	153,169	139,978
	347,588	244,482
Other assets	38,969	39,975
	$554,890	$449,656
LIABILITIES		
Current liabilities:		
Bank and other short term indebtedness	$ 3,061	$ 971
Accounts payable and accrued liabilities	101,466	90,951
Due to customers for returnable containers	21,532	—
Production and sales taxes	18,053	19,355
Dividends payable	3,113	2,681
Total current liabilities	147,225	113,958
Long term liabilities	67,892	6,288
Total liabilities	215,117	120,246
DEFERRED INCOME TAXES	59,780	51,851
SHAREHOLDERS' EQUITY		
Capital Stock:		
Preference shares	41,520	41,770
Common shares	78,357	78,357
	119,877	120,127
Retained earnings	163,863	160,087
Unrealized foreign currency translation adjustments	(3,747)	(2,655)
Total shareholders' equity	279,993	277,559
	$554,890	$449,656

MANAGEMENT REPORT

The consolidated financial statements of Rothmans of Pall Mall Canada Limited and its subsidiary companies have been prepared by management and are in accordance with accounting principles generally accepted in Canada, which conform in all material respects with international accounting standards adopted by the International Accounting Standards Committee relating to the presentation of historical cost financial information. The significant accounting policies are outlined on page 21. All other financial and operating information in the annual report is consistent with that contained in the financial statements.

Management is responsible for maintaining a system of internal accounting controls which provides reasonable assurance that assets are safeguarded and that reliable financial information is produced. Management believes that existing internal controls are appropriate in terms of cost and risk to meet these objectives. Internal auditors employed by the Company and its subsidiaries monitor accounting records and related systems.

Price Waterhouse has been appointed by the shareholders as independent auditors to examine and report on the Company's consolidated financial statements and their report appears below. As part of their examination, Price Waterhouse review internal control systems to the extent deemed necessary to support their opinion on such financial statements.

The Company's board of directors has overall responsibility for and has approved the financial statements and all other information in the annual report. The Board has appointed an Audit Committee consisting of three outside directors to review the audited financial statements prior to their submission to the full Board. The Committee also meets periodically throughout the year with Company officials, internal auditors and Price Waterhouse.

President and Chief Executive Officer	Vice President Finance and Corporate Services

May 23, 1985

AUDITORS' REPORT

May 23, 1985

TO THE SHAREHOLDERS OF
ROTHMANS OF PALL MALL CANADA LIMITED:

We have examined the consolidated statements of earnings, changes in financial position and retained earnings of Rothmans of Pall Mall Canada Limited for the year ended March 31, 1985 and the consolidated balance sheet as at that date. Our examination was made in accordance with generally accepted auditing standards, and accordingly included such tests and other procedures as we considered necessary in the circumstances.

In our opinion, these consolidated financial statements present fairly the results of operations and the changes in financial position of the Company for the year ended March 31, 1985 and its financial position as at that date in accordance with generally accepted accounting principles applied on a basis consistent with that of the preceding year.

Price Waterhouse

Chartered Accountants

SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

The financial statements are prepared on the historical cost basis in accordance with accounting principles generally accepted in Canada and conform in all material respects with international accounting standards adopted by the International Accounting Standards Committee relating to the presentation of historical cost financial information.

Principles of Consolidation

The consolidated financial statements include the accounts of the Company and all of its subsidiaries. The principal subsidiary companies are listed on page 2 of the annual report. Purchase accounting has been followed for all acquisitions and the results of operations of subsidiaries are included from effective dates of acquisition.

For certain subsidiaries of Carling O'Keefe Limited acquired prior to April l, 1974, the excess of the cost of shares over the recorded value of underlying net tangible assets at dates of acquisition is carried at cost and is not amortized. Intangible assets acquired subsequently and sports franchises are amortized over periods not exceeding forty years.

Foreign Exchange

The assets and liabilities of self-sustaining foreign subsidiaries are translated into Canadian dollars at year-end exchange rates; income and costs are translated at average rates of exchange during the year; unrealized foreign currency translation adjustments are reflected in shareholders' equity. All other foreign exchange gains and losses are included in earnings.

Inventories

Inventories, other than returnable containers, are stated at the lower of average cost and net realizable value. Returnable containers are recorded at amortized cost, which is lower than new replacement cost.

Property, Plant and Equipment

Property, plant and equipment are recorded at cost. Depreciation is provided on the straight-line basis over the estimated service lives of the assets, which are as follows for the principal asset categories:

Buildings	— 15 to 40 years
Machinery and equipment	— 5 to 15 years
Motor vehicles	— 3 to 10 years
Leasehold improvements	— term of lease, not to exceed 10 years

Oil and gas assets are accounted for using the full cost method, whereby all costs of exploration and development are capitalized on a country by country basis. Such capitalized costs, net of amortization, cannot exceed net revenues from estimated future production of proved reserves at current prices and costs and the estimated fair market value of properties. Costs are amortized against income using the unit of production method based on proved oil and gas reserves.

Other Assets

Other assets are recorded at cost or amortized cost.

Pensions

Current service costs are charged to operations as they accrue. Prior service costs arising from amendments to the plans and actuarial gains or losses are charged to operations generally over periods of up to fifteen years.

Marketing Costs

Marketing costs, including those related to the introduction of new brands, are charged against earnings during the year in which they are incurred, except for the costs of certain rights which are deferred and amortized over the terms of the respective contracts.

Investment Tax Credits

Net investment tax credits relating to capital and research and development expenditures are accounted for as a reduction of income tax expense in the year earned.

Earnings Per Common Share

Earnings per Common share are calculated after deducting dividends on Preferred shares and are based on the weighted average number of shares outstanding during the year.

ROTHMANS OF PALL MALL CANADA LIMITED
AND SUBSIDIARY COMPANIES
(incorporated under the laws of Canada)

CONSOLIDATED STATEMENT OF EARNINGS

(in thousands of dollars)

	Year ended March 31	
	1985	1984
Income:		
Sales	$1,472,899	$1,490,706
Excise and sales taxes	615,866	611,740
	857,033	878,966
Investment and other income	3,600	6,512
	860,633	885,478
Costs:		
Raw materials and manufacturing	457,622	432,743
Marketing and distribution	292,156	276,442
Administrative and general	63,217	55,315
Interest on long term debt	3,180	2,322
Other interest	1,209	1,009
	817,384	767,831
Earnings before income taxes and minority interest	43,249	117,647
Income taxes (Note 11):		
Current	1,333	32,771
Deferred	8,788	10,909
	10,121	43,680
Earnings before minority interest	33,128	73,967
Minority interest (Note 3)	8,836	28,108
EARNINGS FOR THE YEAR	$ 24,292	$ 45,859
Earnings per Common share	$4.09	$8.00

CONSOLIDATED BALANCE SHEET

(in thousands of dollars)

	March 31 1985	March 31 1984
ASSETS		
Current assets:		
Cash and short term investments	$ 4,334	$ 11,705
Accounts receivable	82,143	75,367
Income taxes	8,965	—
Inventories (Note 4)	278,060	253,427
Prepaid expenses	10,502	8,443
Total current assets	384,004	348,942
Property, plant and equipment (Note 5)	599,365	475,463
Less: Accumulated depreciation and depletion	204,745	189,576
	394,620	285,887
Other assets (Note 6)	39,542	40,558
	$818,166	$675,387
LIABILITIES		
Current liabilities:		
Bank and other short term indebtedness (Note 7)	$ 56,212	$ 29,816
Accounts payable and accrued liabilities	121,425	108,498
Due to customers for returnable containers	21,532	—
Income taxes	—	457
Excise, sales and other taxes	33,603	34,061
Dividends payable	1,804	1,590
Total current liabilities	234,576	174,422
Long term liabilities (Note 8)	81,342	21,338
Total liabilities	315,918	195,760
DEFERRED INCOME TAXES	69,268	60,617
MINORITY INTEREST IN SUBSIDIARY COMPANY (Note 3)	160,469	159,381
SHAREHOLDERS' EQUITY		
Capital stock (Note 9)	53,371	53,825
Retained earnings	221,018	207,135
Unrealized foreign currency translation adjustments (Note 2)	(1,878)	(1,331)
Total shareholders' equity	272,511	259,629
	$818,166	$675,387

APPROVED BY THE BOARD:

John H. Devlin Director

R. O. J. Dawkes Director

CONSOLIDATED STATEMENT OF CHANGES IN FINANCIAL POSITION

(in thousands of dollars)

	Year ended March 31	
	1985	1984
Cash provided by(used for):		
Operations—		
Earnings for the year	$ 24,292	$ 45,859
Adjusted for non-cash items—		
Depreciation and depletion	23,727	17,446
Minority interest in earnings	8,836	28,108
Deferred income taxes	8,788	10,909
Other items	807	1,455
	66,450	103,777
Disposal of assets	2,458	1,422
Additions to property, plant and equipment	(135,026)	(82,103)
Additions to other assets	(445)	(2,948)
Increase in operating working capital*	(9,567)	(2,655)
	(76,130)	17,493
Financing activities—		
Increase (decrease) in long term liabilities	58,632	(4,425)
Current portion of other assets	1,797	—
Dividends—		
By the Company	(10,577)	(10,615)
By a subsidiary company to minority shareholders	(7,005)	(6,038)
Other	(484)	(497)
	42,363	(21,575)
Increase in net short term indebtedness	(33,767)	(4,082)
Net short term indebtedness at beginning of year	(18,111)	(14,029)
Net short term indebtedness at end of year	$ (51,878)	$ (18,111)
Comprised of:		
Cash and short term investments	$ 4,334	$ 11,705
Bank and other short term indebtedness	(56,212)	(29,816)
	$ (51,878)	$ (18,111)

* Operating working capital consists of working capital excluding cash, short term investments and short term indebtedness.

CONSOLIDATED STATEMENT OF RETAINED EARNINGS
(in thousands of dollars)

	Year ended March 31	
	1985	1984
Balance at beginning of year	$207,135	$171,686
Earnings for the year	24,292	45,859
Excess of carrying value over cost of First Preferred shares purchased for cancellation (Note 9)	116	152
Excess of carrying value over cost of preference shares purchased for cancellation by a subsidiary company, less minority interest	52	53
	231,595	217,750
Dividends paid:		
Preferred shares—		
First Preferred shares, Series A ($6.85 per share)	856	894
Second Preferred shares ($1.325 per share)	904	904
	1,760	1,798
Common shares ($1.60 per share)	8,817	8,817
	10,577	10,615
Balance at end of year	$221,018	$207,135

CONSOLIDATED ANALYSIS OF CHANGES IN OPERATING WORKING CAPITAL
(in thousands of dollars)

	Year ended March 31	
	1985	1984
Accounts receivable	$ (6,776)	$ (6,744)
Inventories	(24,633)	(9,498)
Prepaid expenses	(2,059)	(1,385)
Accounts payable, accrued liabilities and dividends payable	13,142	33,651
Due to customers for returnable containers	21,532	—
Income taxes	(9,422)	(20,084)
Excise, sales and other taxes	(458)	1,863
Unrealized foreign currency translation adjustments	(893)	(458)
Increase in operating working capital	$ (9,567)	$ (2,655)

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

MARCH 31, 1985 AND 1984

1. SEGMENTED INFORMATION

In these financial statements, all references to "Rothmans" relate to the tobacco operations of the Company and its tobacco subsidiaries. All references to "Carling O'Keefe" relate to activities of the Company's majority-owned (50.1%) subsidiary, Carling O'Keefe Limited, which include the production and sale of beer, wine and oil and gas.

	1985	1984
SALES:		
ROTHMANS	$ 558,343,000	$ 542,240,000
CARLING O'KEEFE—		
Beer	833,449,000	869,287,000
Wine	57,731,000	59,348,000
Oil and gas	23,376,000	19,831,000
	$1,472,899,000	$1,490,706,000
OPERATING PROFITS:		
ROTHMANS	$ 28,656,000	$ 32,574,000
CARLING O'KEEFE—		
Beer	8,154,000	73,043,000
Wine	3,225,000	5,596,000
Oil and gas	10,015,000	9,089,000
Corporate income (expense), net	(2,412,000)	676,000
	47,638,000	120,978,000
Interest expense	(4,389,000)	(3,331,000)
Earnings before income taxes and minority interest	$ 43,249,000	$ 117,647,000
CAPITAL EXPENDITURES:		
ROTHMANS	$ 10,569,000	$ 8,303,000
CARLING O'KEEFE—		
Beer	109,310,000	63,174,000
Wine	4,153,000	1,855,000
Oil and gas	10,994,000	8,771,000
	$ 135,026,000	$ 82,103,000

	1985	1984
DEPRECIATION AND DEPLETION:		
ROTHMANS	$ 4,306,000	$ 3,107,000
CARLING O'KEEFE—		
Beer	13,327,000	9,608,000
Wine	1,529,000	1,419,000
Oil and gas	4,565,000	3,312,000
	$ 23,727,000	$ 17,446,000
IDENTIFIABLE ASSETS:		
ROTHMANS	$263,276,000	$226,259,000
CARLING O'KEEFE—		
Beer	422,474,000	317,892,000
Wine	58,534,000	57,680,000
Oil and gas	73,090,000	66,091,000
Corporate	792,000	7,465,000
	$818,166,000	$675,387,000

Corporate assets consist of cash, short term investments and mortgage receivable of Carling O'Keefe.

2. CHANGE IN ACCOUNTING POLICY

In accordance with recommendations of the Canadian Institute of Chartered Accountants, Carling O'Keefe changed its policy of accounting for foreign exchange adjustments arising from translation of the accounts of self-sustaining foreign subsidiaries. This change was applied on a prospective basis effective April 1, 1983. The change primarily affects the method of translating into Canadian dollars the property, plant and equipment of foreign subsidiaries. As a result, unrealized foreign exchange gains and losses are included as a separate account in shareholders' equity. The change had no significant effect on the consolidated financial statements for the years ended March 31, 1985 and 1984.

Movements in the unrealized foreign currency translation adjustments account, after deduction of minority interest, for the years ended March 31 were as follows:

	1985	1984
Balance at beginning of year	$1,331,000	$1,033,000
Adjustments for the year	547,000	298,000
Balance at end of year	$1,878,000	$1,331,000

Prior to the 1984 fiscal year, current assets and liabilities of these subsidiaries were translated at year-end exchange rates, other balance sheet accounts and depreciation expense were translated at historical rates of exchange, and income and other costs were translated at average rates of exchange during the year. The resulting exchange gains or losses were included in earnings.

3. MINORITY INTEREST IN SUBSIDIARY COMPANY

The interest of minority shareholders in the consolidated earnings of Carling O'Keefe Limited for the years ended March 31 was as follows:

	1985	1984
Preference shares	$ 2,011,000	$ 2,022,000
Common shares	6,825,000	26,086,000
	$ 8,836,000	$ 28,108,000

The minority shareholders' interest in the capital stock and retained earnings of Carling O'Keefe Limited at March 31 was as follows:

	1985	1984
Preference shares	$ 41,520,000	$ 41,770,000
Common shares	118,949,000	117,611,000
	$160,469,000	$159,381,000

4. INVENTORIES

	1985	1984
ROTHMANS—		
Leaf tobacco	$ 98,274,000	$ 80,646,000
Finished goods	68,090,000	58,344,000
Packaging material and other	14,423,000	14,721,000
	180,787,000	153,711,000
CARLING O'KEEFE—		
Beverage products, finished and in process	47,523,000	51,739,000
Materials and supplies	27,633,000	24,377,000
Returnable containers	22,117,000	23,600,000
	97,273,000	99,716,000
	$278,060,000	$253,427,000

Private mould bottles of Carling O'Keefe are carried at amortized cost and the liability for returnable containers held by customers is recorded at deposit value and disclosed separately. Raw materials and manufacturing costs included a charge of $20,600,000 in 1985 for the write-off of compact bottles in inventory and in the hands of customers.

5. PROPERTY, PLANT AND EQUIPMENT

	1985		1984	
	Cost	Accumulated depreciation and depletion	Cost	Accumulated depreciation and depletion
ROTHMANS—				
Land	$ 2,449,000	$ —	$ 2,589,000	$ —
Buildings	11,635,000	4,168,000	10,497,000	3,947,000
Machinery and equipment	69,468,000	35,434,000	63,777,000	34,223,000
Motor vehicles	5,159,000	4,413,000	5,074,000	4,347,000
Leasehold improvements	9,897,000	7,561,000	9,066,000	7,081,000
	98,608,000	51,576,000	91,003,000	49,598,000
CARLING O'KEEFE—				
Land	9,164,000	—	8,471,000	—
Buildings	138,593,000	31,788,000	103,057,000	29,671,000
Machinery and equipment	228,983,000	78,448,000	162,863,000	73,800,000
Motor vehicles	21,727,000	10,901,000	19,283,000	9,867,000
Oil and gas assets	97,773,000	29,677,000	86,491,000	24,664,000
Leasehold improvements	4,517,000	2,355,000	4,295,000	1,976,000
	500,757,000	153,169,000	384,460,000	139,978,000
	$599,365,000	$204,745,000	$475,463,000	$189,576,000

Effective April I, I983, Rothmans changed the depreciation period for machinery and equipment from 10 years to 15 years. As a result, depreciation expense for the 1985 and 1984 fiscal years was reduced by approximately $1,750,000 and $1,300,000 respectively.

6. OTHER ASSETS

	1985	1984
ROTHMANS—		
Unamortized deferred charges, trade marks and patents	$ 573,000	$ 583,000
CARLING O'KEEFE—		
Unamortized cost of shares of subsidiaries in excess of underlying net tangible asset values at acquisition	21,028,000	21,321,000
Unamortized cost of sports franchises	11,273,000	11,603,000
Deferred charges and other investments	6,668,000	7,051,000
	38,969,000	39,975,000
	$39,542,000	$40,558,000

Amortization of other assets amounted to $705,000 for the year ended March 31, I985 (1984—$703,000).

7. BANK AND OTHER SHORT TERM INDEBTEDNESS

Bank and other short term indebtedness consists of bank indebtedness of $26,212,000 (1984—$22,816,000) and notes payable of $30,000,000 (1984—$7,000,000).

	1985	1984
ROTHMANS	**$53,151,000**	$28,845,000
CARLING O'KEEFE	**3,061,000**	971,000
	$56,212,000	$29,816,000

8. LONG TERM LIABILITIES

	1985	1984
ROTHMANS—		
Sinking fund debentures—		
Series A 8% due January 3, 1988	**$ 3,021,000**	$ 3,331,000
Series B 11% due February 15, 1995	**11,267,000**	12,647,000
	14,288,000	15,978,000
CARLING O'KEEFE—		
Sinking fund debentures—		
Series D 5½% due April 1, 1986	**800,000**	1,600,000
Series E 5½% due April 1, 1989	**3,455,000**	3,831,000
	4,255,000	5,431,000
Term bank loans	**62,000,000**	—
Obligations under capital leases	**83,000**	200,000
Advances under gas contracts	**1,511,000**	1,782,000
Unfunded pensions (Note 10)	**1,597,000**	—
	69,446,000	7,413,000
	83,734,000	23,391,000
Less—Amount included in current liabilities	**2,392,000**	2,053,000
	$81,342,000	$21,338,000

The remaining principal requirements for long term liabilities are as follows for the years ending March 31:

	1986	1987	1988	1989	1990
ROTHMANS	$ 838,000	$ 1,600,000	$ 2,250,000	$ 800,000	$ 800,000
CARLING O'KEEFE	1,554,000	13,279,000	51,279,000	1,279,000	279,000
	$2,392,000	$14,879,000	$53,529,000	$2,079,000	$1,079,000

During 1985, Carling O'Keefe entered into bank loan arrangements for $125,000,000 of floating rate revolving credits, which mature at the earliest in the 1987 and 1988 fiscal years and which may be extended. As at March 31, 1985, $62,000,000 had been drawn down under these arrangements. The average interest rate was 10.8% during fiscal 1985 and 11.1% at March 31, 1985.

The Rothmans debentures are secured by a floating charge on the Company's assets in the provinces of Ontario and Quebec.

An affiliated company owns $1,919,000 principal amount of the Company's outstanding Series A debentures.

Containers and equipment leased under capital leases by Carling O'Keefe are included in their respective asset categories and are depreciated accordingly.

9. CAPITAL STOCK

AUTHORIZED:

469,889 First Preferred shares issuable in series
2,817,062 Second Preferred shares
An unlimited number of Common shares

ISSUED:

	1985	1984
123,753 6.85% Cumulative Redeemable First Preferred shares, Series A (1984—128,293)	**$12,375,000**	$12,829,000
682,367 6⅝% Cumulative Redeemable Second Preferred shares	**13,647,000**	13,647,000
	26,022,000	26,476,000
5,510,684 Common shares	**27,349,000**	27,349,000
	$53,371,000	$53,825,000

PURCHASES:

During the year ended March 31, 1985, 4,540 First Preferred shares with a total carrying value of $454,000 were purchased for cancellation at a cost of $338,000 (1984—5,051 shares).

REDEMPTION PRIVILEGES:

The Series A First Preferred shares are redeemable at the option of the Company at $102 per share if redeemed before January 27, 1989 and at $101 per share if redeemed on or after January 27, 1989. The Company is required to purchase 5,000 of these shares in each calendar year. At March 31, 1985, 1,247 shares of the 1985 requirement had been acquired.

The Second Preferred shares are redeemable at the option of the Company at $20 per share.

OWNERSHIP:

Rothmans of Canada Limited, a wholly-owned subsidiary of Rothmans International p.l.c., is the owner of 71.2% of the Company's issued Common shares and 20.2% (1984—19.5%) of the issued Series A First Preferred shares.

10. PENSIONS

The Company and its subsidiaries maintain pension plans for employees and generally fund pensions with independent trustees in accordance with legal requirements. Certain supplementary pensions are unfunded and charged to operations when paid. The charge against earnings was $10,730,000 for the year ended March 31, 1985 (1984—$9,948,000), including $7,649,000 (1984—$6,997,000) for employees of Carling O'Keefe.

Based on recent independent actuarial valuations, the unfunded pension liability for Carling O'Keefe is estimated at $18,426,000. The unfunded liability, including a vested liability of $1,597,000, is being charged to operations generally over periods of up to fifteen years, as described in the summary of significant accounting policies.

11. INCOME TAXES

The difference between a basic income tax rate of 50% and the effective income tax rate based on tax legislation is explained as follows:

	1985	1984
ROTHMANS—		
Income taxes at basic rate	**$13,276,000**	$15,001,000
Incentives	**(3,241,000)**	(3,838,000)
Investment tax credits	**(597,000)**	(914,000)
Other—net	**(320,000)**	106,000
	9,118,000	10,355,000
CARLING O'KEEFE—		
Income taxes at basic rate	**8,349,000**	43,822,000
Incentives	**(1,254,000)**	(6,328,000)
Investment tax credits	**(4,626,000)**	(2,500,000)
Alberta Royalty Tax Credit	**(1,750,000)**	(2,066,000)
Other—net	**284,000**	397,000
	1,003,000	33,325,000
Income taxes—consolidated statement of earnings	**$10,121,000**	$43,680,000
Effective income tax rate	**23.4%**	37.1%

Incentives include manufacturing and processing credits, inventory allowances and resource and depletion allowances, net of royalties.

Deferred income taxes primarily reflect timing differences between accounting and tax depreciation, less the provision for compact bottle write-off as at March 31, 1985.

12. COMMITMENTS AND CONTINGENT LIABILITIES

In the normal course of business, the Company and its subsidiaries have commitments which include royalties payable under licensing agreements, capital expenditures, and the purchase of television rights and agricultural products.

Commitments under operating lease obligations relate to sports facilities, warehouses, retail stores and offices. The following table summarizes the minimum rental payments due after March 31, 1985:

	Rothmans	Carling O'Keefe	Total
Year ending March 31—			
1986	$ 1,831,000	$ 4,976,000	$ 6,807,000
1987	1,758,000	3,934,000	5,692,000
1988	1,674,000	3,058,000	4,732,000
1989	1,646,000	2,462,000	4,108,000
1990	1,646,000	2,127,000	3,773,000
Years subsequent to March 31, 1990	1,798,000	5,920,000	7,718,000
	$10,353,000	$22,477,000	$32,830,000

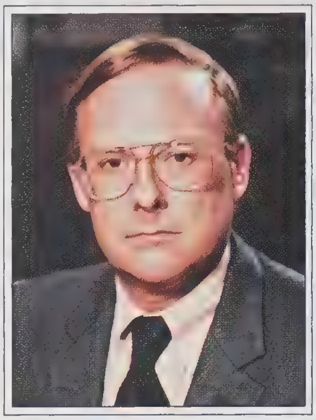
There are a number of outstanding claims and legal actions involving the Company and its subsidiaries. In the opinion of mangement, the outcome of these matters should have no material effect on the Company's financial position.

FIVE-YEAR FINANCIAL REVIEW

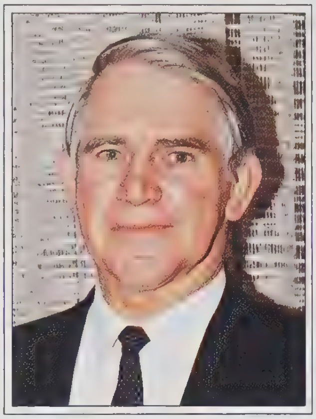
	Year Ended March 31				
	1985	1984	1983	1982	1981
Results For The Year ($000)					
Sales—					
Rothmans	**$ 558,343**	$ 542,240	$ 512,213	$ 485,406	$461,491
Carling O'Keefe	**914,556**	948,466	784,227	644,133	537,348
	1,472,899	1,490,706	1,296,440	1,129,539	998,839
Excise and sales taxes	**615,866**	611,740	529,793	462,364	409,595
	857,033	878,966	766,647	667,175	589,244
Earnings—					
Earnings from operations:					
Rothmans	**17,434**	19,647	21,026	22,221	21,391
Carling O'Keefe, less minority interest	**6,858**	26,212	18,060	10,389	8,882
Earnings before extraordinary items	**24,292**	45,859	39,086	32,610	30,273
Extraordinary items from Carling O'Keefe, less minority interest	**—**	—	—	—	5,263
Earnings for the year	**24,292**	45,859	39,086	32,610	35,536
Depreciation and depletion	**23,727**	17,446	23,264	17,032	15,303
Interest expense	**4,389**	3,331	7,273	9,460	8,019
Dividends paid—					
Preferred	**1,760**	1,798	1,835	1,861	1,894
Common	**8,817**	8,817	8,817	8,541	7,439
Financial Position ($000)					
Working capital	**$149,428**	$174,520	$176,405	$157,624	$133,519
Property, plant and equipment—net	**394,620**	285,887	224,515	207,164	194,655
Total assets	**818,166**	675,387	616,475	565,535	503,854
Total interest-bearing debt	**136,755**	51,225	74,515	99,569	79,069
Shareholders' equity	**272,511**	259,629	226,017	197,744	175,846
Per Common Share					
Earnings—					
Before extraordinary items	**$ 4.09**	$ 8.00	$ 6.76	$ 5.58	$ 5.15
For the year	**4.09**	8.00	6.76	5.58	6.11
Dividends paid	**1.60**	1.60	1.60	1.55	1.35
Shareholders' equity	**44.71**	42.29	36.10	30.91	26.82
Other Information					
Return on average total capital employed (%)	**7.7**	17.2	14.3	13.3	12.9
Return on shareholders' equity (%)	**9.1**	18.9	18.4	17.5	18.6
Capital expenditures ($000)	**135,026**	82,103	41,340	30,610	35,109
Working capital ratio	**1.64**	2.00	2.00	1.94	1.97

DIRECTORS

RENÉ AMYOT, Q.C., LL.L., M.B.A.



DOUGLAS G. BASSETT



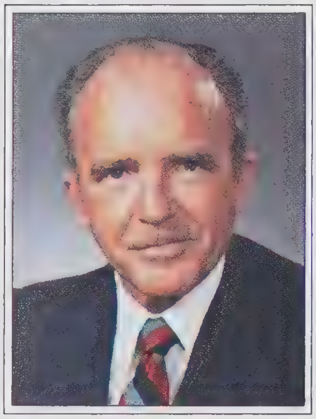
VERNON A.BRINK

MONA L. CAMPBELL, LL.D.

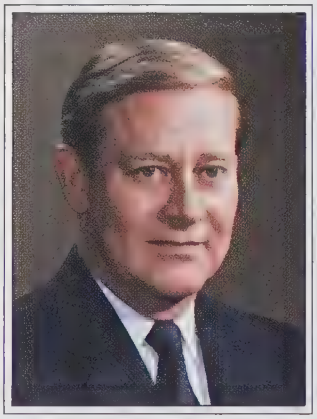
SIR ROBERT CRICHTON-BROWN
K.C.M.G., C.B.E., T.D.

JOHN H. DEVLIN

ROBERT H. HAWKES, Q.C.



THE HON. WILLIAM M. KELLY
B.A.Sc., M.E.I.C.



S. RODERICK MCINNES, C.A.

JOHN J. WETTLAUFER
M.B.A., LL.D.

OFFICERS

John H. Devlin, Chairman of the Board **Robert H. Hawkes,** Q.C., President and Chief Executive Officer
Robert W. Allan, C.A., Vice President Leaf and Research **Warren A. Brackmann,** Vice President Research and Technical Development
John E. Broen, Vice President Marketing Planning **David S. Broome,** Vice President Marketing
Camille A. Denis, Vice President Corporate Affairs **Ronald F. Findlay,** C.A., Vice President Finance and Corporate Services
Joseph J. Heffernan, Vice President Manufacturing **John J.Morrissey,** Vice President Personnel and Industrial Relations
Hugh R.Sampson, C.A., Vice President and Treasurer **James K. Strickland,** Vice President, General Counsel and Secretary
Gordon R. White, Vice President Sales **Edward A. Crighton,** C.A., Comptroller **Brenda Moher,** Assistant Secretary

DIRECTORS AND COMMITTEES OF THE BOARD OF DIRECTORS

The Board of Directors generally meets 8 or 9 times a year to discuss, review and act on significant matters affecting the Company. Of the ten members currently serving, Mr. Devlin is the Chairman and Mr. Hawkes is the President and Chief Executive Officer of Rothmans; Mr. McInnes is the Chairman, President and Chief Executive Officer of the Company's majority-owned subsidiary, Carling O'Keefe Limited; Sir Robert Crichton-Brown is the Chairman and Mr. Brink is the Chief Executive of Rothmans International p.l.c. of London, England, the parent company of Rothmans Canada. On March 31, 1985, having reached the age of 65, Mr. Devlin retired as an employee of the Company. At the request of the Board, he has agreed to remain as Chairman until the Annual General Meeting in 1986. Brief biographies of the five outside directors, who are all employed outside of the Rothmans World Group, are as follows:

MR. AMYOT of Quebec, Quebec is Counsel to the firm of Jolin, Fournier & Associates, barristers and solicitors; he has been a director of the Company since 1980; Mr. Amyot is a director of a number of other Canadian companies, including The Imperial Life Assurance Company of Canada, Logistec Corporation and Champion Pipe Line Limited.

MR. BASSETT of Toronto, Ontario is President and Chief Executive Officer of Baton Broadcasting Inc. and has been a Rothmans director since 1983; he has a number of other corporate directorships, including Argus Corporation Limited, Canadian Imperial Bank of Commerce, Eaton's of Canada Limited, Norcen Energy Resources Limited and Ravelston Corporation Limited.

MRS. CAMPBELL of Toronto, Ontario is President of Dover Industries Limited; she has been a board member since 1981 and is also a director of The Toronto-Dominion Bank and the Women's College Hospital Foundation.

SENATOR KELLY of Toronto, Ontario is President of Kelco Management Ltd., Chairman of Health Assistance for Travellers Inc., and a director of First City Financial Corporation and ConTrans Inc; he joined the Company's board of directors in 1984.

MR. WETTLAUFER of London, Ontario is Professor Emeritus at the School of Business Administration, the University of Western Ontario; he became a Company director in 1981; he also serves as a director for Hayes-Dana Inc., S.C. Johnson & Son Ltd. and the London Life Insurance Company.

COMMITTEES OF THE BOARD OF DIRECTORS

Audit—This committee is composed of three outside directors, with the present members being Messrs. Wettlaufer (Chairman), Amyot and Kelly; it generally meets four times a year.

Human Resources and Compensation—This committee is composed of three directors, one of whom is an officer of the Company; the members are Messrs. Bassett (Chairman), Amyot and Devlin; the committee generally meets two or three times a year.

Pension Investment—This committee presently has seven members, comprised of three directors, one of whom is an officer, and four other officers; members are Mrs. Campbell and Messrs. Crighton (Chairman), Amyot, Findlay, Hawkes, Morrissey and Sampson; the committee generally meets four times a year.

QUARTERLY DATA

	Quarter ended				
	June 30	Sept. 30	Dec. 31	Mar. 31	Total
Consolidated Sales ($000)					
1985—Rothmans	**$146,302**	**$144,509**	**$155,308**	**$112,224**	**$ 558,343**
Carling O'Keefe	**263,909**	**262,741**	**223,082**	**164,824**	**914,556**
	$410,211	**$407,250**	**$378,390**	**$277,048**	**$1,472,899**
1984—Rothmans	$139,253	$146,812	$145,916	$110,259	$ 542,240
Carling O'Keefe	240,866	272,175	241,318	194,107	948,466
	$380,119	$418,987	$387,234	$304,366	$1,490,706
Consolidated Earnings (Loss)					
Amount ($000)					
1985—Rothmans	**$ 4,600**	**$ 5,271**	**$ 6,502**	**$ 1,061**	**$ 17,434**
Carling O'Keefe*	**7,005**	**5,760**	**(4,064)**	**(1,843)**	**6,858**
	$ 11,605	**$ 11,031**	**$ 2,438**	**$ (782)**	**$ 24,292**
1984—Rothmans	$ 5,399	$ 6,374	$ 5,587	$ 2,287	$ 19,647
Carling O'Keefe*	7,686	9,823	6,459	2,244	26,212
	$ 13,085	$ 16,197	$ 12,046	$ 4,531	$ 45,859
Per Common Share—					
1985	**$ 2.03**	**$ 1.92**	**$ 0.36**	**$ (0.22)**	**$ 4.09**
1984	$ 2.29	$ 2.86	$ 2.10	$ 0.75	$ 8.00
Share Market Prices					
First Preferred—					
1985—High	**$75**	**$73**	**$75**	**$77**	
Low	**73**	**71¾**	**72**	**74**	
1984—High	72	72	73	76	
Low	63	68½	70	71¾	
Second Preferred—					
1985—High	**14**	**14**	**14½**	**14¾**	
Low	**13**	**13⅛**	**13⅜**	**13⅝**	
1984—High	14⅝	14	15	15	
Low	12¾	12⅝	13	14	
Common—					
1985—High	**46⅛**	**44¾**	**40¾**	**44**	
Low	**42½**	**40¼**	**39½**	**40¾**	
1984—High	49½	50½	51½	51½	
Low	39½	46	43½	47	

The Company's Preferred and Common shares are listed on the Toronto, Montreal and Vancouver stock exchanges.

* after deducting minority interest.

ROTHMANS OF PALL MALL CANADA LIMITED